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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 42

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CAPITAL GAINS RESEARCH BUREAU, INC. AND HARRY P. SCHWARZMANN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the district court (R. 18-21) is reported at 191 F. Supp. 897. The opinions of the panel of the court of appeals (R. 46-60) and of the court *en banc* on rehearing (R. 62-85) are reported, respectively, at 300 F. 2d 745 and 306 F. 2d 606.

JURISDICTION

The judgment of the court of appeals *en banc* was entered on July 13, 1962 (R. 86). The time within

which to file a petition for a writ of certiorari was extended by Mr. Justice Harlan to and including November 26, 1962 (R. 87, 88). The petition was filed on the latter date, and was granted on January 21, 1963 (R. 89; 371 U.S. 967). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the practice known in the investment business as "scalping" — the purchase by an investment adviser of a stock just prior to his widespread recommendation of the stock to his clients, followed by his sale of the stock at a profit upon the rise in the market price which customarily follows such recommendation, without disclosing his personal interest to his clients—is a "device, scheme, or artifice to defraud" or a "practice * * * which operates as a fraud or deceit" upon the investment adviser's clients in violation of Section 206(1) and (2) of the Investment Advisers Act of 1940.

STATUTES INVOLVED

Prior to its amendment in 1960 (see, *infra*, p. 29), Section 206 of the Investment Advisers Act of 1940, 54 Stat. 847, 15 U.S.C. 80b-6, provided in pertinent part:

> It shall be unlawful for any investment adviser * * *, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

* * * *

Other relevant statutory provisions are set forth in the Appendix, *infra*, pp. 35-37.

STATEMENT

The respondent Capital Gains Research Bureau, Inc., is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (R. 9, 26). The company is operated by respondent Harry P. Schwarzmann, its president and principal stockholder (R. 9, 22). The chief business of Capital Gains is the publication of two investment advisory services. The service involved in the present case is called "A Capital Gains Report," and is described by respondents as "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued" (R. 34). This service consists of a monthly (R. 26) bulletin in which respondents evaluate and recommend the purchase of a single specific security (R. 9, 26). In so doing, respondents may evaluate and report adversely on securities of comparable enterprises (R. 12, 28, 42). The Report is issued to approximately 5,000 subscribers who pay $18.00 per year for the service (R. 9-10, 26-27). In addition, the Report is sometimes also distributed

to nonsubscribers on a mailing list containing approximately 100,000 names (R. 10).

During the period from March 15, 1960, through November 7, 1960, respondents on six different occasions purchased a particular security and shortly issued a Capital Gains Report recommending the security for long-term investment. In each instance, the market price rose and the volume of trading substantially increased within a few days after distribution of respondents' bulletin. Respondents then sold the shares at a profit.[1] In one instance respondents profited not only from the purchase, recommendation and sale of a security (Frank G. Shattuck Co.), but also from selling short a security (Chock Full O'Nuts) which they stated in the bulletin was overpriced in comparison with Shattuck. Prior to the issuance of this bulletin, they had purchased three-month calls on the Shattuck stock and had sold short the stock of Chock Full O'Nuts. After publication of the bulletin, when the price of the Shattuck stock had risen and that of the Chock Full O'Nuts stock had declined, respondents exercised their call options on the former and covered their short sales of the latter, in each instance at a profit.

Typical of respondents' dealings were their transactions in the stock of Continental Insurance Co. On

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[1] One of these transactions took the form of the purchase of "calls" upon the security—that is, the right to purchase a designated number of shares during a stated period for a specified price—followed by their exercise after the price had risen. When we refer to respondents' purchases and sales involved in this case, we include the transactions accomplished through the "calls."

March 15, 1960, respondents purchased 500 shares of this stock at 47¾ and 47⅞ (R. 10). Three days later, on March 18, they mailed their report recommending purchase of the stock "for gradual but substantial appreciation" (R. 10, 34-35). Following this recommendation, the volume of trading in the stock increased (approximately threefold and fourfold, respectively, on the two business days immediately following), and the price rose (R. 15). Respondents sold the stock on March 29, 1960—11 days after their recommendation—at 50⅛, for a profit of $1,125.00 (R. 10; see note 2, *infra*, p. 7).

The timing and profits of respondents' purchases, recommendations and sales of the seven securities may be summarized as follows (the details are set forth at R. 9-17):

Stock	Purchased	Purchase Price	Recommended	Sold	Sale Price	Profit
Continental Insurance Co.	3/15/60	47-3/4, 47-7/8	3/18/60	3/29/60	50-1/8	$1,125.00
United Fruit Co.	5/13, 16, 19, 20/60	21-1/4-22-1/8	5/27/60	6/6, 7, 9, 10/60	23-5/8-24-1/2	$10,725.00
Creole Petroleum Corp.	7/5, 14/60	25-1/4-28-3/4	7/15/60	7/20, 21, 22/60	27-1/8-29	$1,762.50
Hart, Schaffner & Marx.	8/8/60	23	8/12/60	8/18, 22/60	24-7/8, 25-1/4	$837.00
Union Pacific	10/28, 31/60	25-3/8-25-5/8	11/1/60	11/7/60	27	$1,757.00
Frank G. Shattuck Co.	10/11/60 (purchased calls).	16.83 (2.53 call cost, plus 14.30 option price)	10/14/60	10/25/60 (exercised calls and sold)	19-1/2-20-1/8	$695.17
Chock Full O'Nuts	10/4/60 (sold short)	68-3/4-69 (sale price)	10/14/60 (disparaged)	10/24/60 (covered short sale)	62,62-1/2 (purchase price)	$2,772.33

[3] Respondents contend (Br. in Opp., 7) that we have overstated their profits on the transactions in Continental Insurance, Creole Petroleum, and Union Pacific, and that on Chock Full O'Nuts they incurred a loss rather than making a profit.

1. *Continental Insurance.* The difference between our figures and respondents' stems largely from their inclusion of transactions in these stocks which we deem inapplicable to the question in this case. Thus, respondents included transactions in Continental Insurance Company stock purchased *four days after* the mailing of their bulletin, which shares were sold at a loss nine days thereafter (R. 29). This loss was not included in our profit figure of $1125, which includes only transactions where respondents made their purchases prior to the publication of their bulletin. It is computed from data, which have not been disputed, set forth in the affidavit of the Commission investigator (R. 10, 15). Where the exact sale or purchase prices are not set forth in the affidavit, we have used respondents' minimum profits calculated by assuming that respondents purchased at the high of the day when the particular purchase was made and sold at the low of the day when the particular sale was made.

2. *Creole Petroleum Company.* As in the case of Continental Insurance Company, our profit figure of $1,762.50 is computed from unchallenged data set forth in the record (R. 11, 16) and similarly shows only respondents' minimum profits. Although respondent Schwarzmann stated in his affidavit that the profits on transactions in this stock were $569 (R. 31), neither the affidavit nor the record indicates how this lower amount was determined.

3. *Union Pacific.* Computations made as were those for Creole Petroleum Corporation and Continental Insurance Company, would show a minimum profit of $2,750 (R. 12-13). The table uses $1,757, however, since this smaller profit was given in the affidavit of the Commission investigator. Respondent Schwarzmann's affidavit gives a profit of $1,600 (R. 31), but without any explanation of the basis therefor.

4. *Chock Full O'Nuts.* Respondents' claim that they suffered a loss in this stock is based on their purchases of "puts" (options to sell a stock at a specified price during a stated period) which, according to Schwarzmann's affidavit, were neither sold nor exercised but became "completely worthless" (R. 28-29). When the affidavit was executed (December 13, 1960, R. 33), however, the "puts" had not yet expired; their expiration dates ranged from January 3 to January 16, 1961 (R. 12). The record does not show the value of the "puts" on the date of the affidavit, or indicate why respondents had failed to exercise them earlier.

Respondents did not disclose any aspect of any of the foregoing transactions to their clients (R. 13-14, 34-44).

In November 1960, the Commission commenced an action in the district court alleging that respondents had "employed devices, schemes and artifices to defraud clients and prospective clients" and "engaged in transactions, practices and courses of business which operate and have operated as a fraud and deceit" upon such clients in violation of Section 206(1) and (2) of the Investment Advisers Act (R. 1-4). The Commission sought an injunction to require respondents to disclose the material facts concerning their practices as part of any future bulletin (R. 3-4). The district court denied a preliminary injunction, holding that the foregoing facts did not establish a violation of the statute.[3] On appeal, a panel of the court of appeals, one judge dissenting, affirmed (R. 46-60). Subsequently, the court *en banc* reaffirmed the district court's order in a 5-4 decision (R. 62-85).[4]

While recognizing (R. 65) that the "federal securities laws are to be construed broadly to effectuate

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[3] The district court ruled that the words "fraud" and "deceit" were used in Section 206 in a "technical sense" and required proof either that respondents intended that their clients lose money or that the clients had in fact suffered losses as a result of respondents' advice (R. 20-21).

[4] The opinion of the court *en banc* (R. 62-70) was written by Judge Moore and joined in by Chief Judge Lumbard and Judges Waterman, Friendly and Hays; the dissenting opinion (R. 71-85), written by Judge Clark, was joined in by Judges Smith, Kaufman and Marshall.

their remedial purpose" and that "a relationship of trust and confidence should exist between the advisor and the advised," the majority held that respondents had not violated their fiduciary duty to their clients by failing to disclose their holdings of the stocks recommended and their practice of selling those securities shortly after their recommendations, and thus profiting "personally from the predictable market effect of [their] * * * honest advice." The court held that the statute requires the Commission to prove that the individual security recommendations were made in bad faith, and the court refused to infer bad faith from respondents' practice. The majority indicated that if, at the trial, the Commission were able to establish that the respondent firm made its recommendations "for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such conduct might well find itself within the prohibitions of Section 206(1) and (2)" (*ibid.*).

The four dissenters stated (R. 81):

> Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally instilled in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its

clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

SUMMARY OF ARGUMENT

The issue is whether respondents, in the conduct of an investment advisory service designed to aid investors in making long-term capital gains, violated Section 206(1) and (2) of the Investment Advisers Act by "scalping"—that is, by purchasing a stock shortly before recommending it, and then selling it at a profit a few days later upon the rise in price which customarily follows such a recommendation, but without disclosing the practice to their clients. Respondents, as investment advisers, were under a fiduciary obligation to render disinterested advice to their clients and they violated that duty by secretly trading upon the predictable market effect of their recommendations. In our view this breach of respondents' fiduciary duty violated Section 206(1) and (2), which makes it unlawful for an investment adviser (1) "to employ any device, scheme, or artifice to defraud any client or prospective client;" or, (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

A. An investment adviser is a fiduciary, and he must therefore render completely disinterested advice. Investment advice is not disinterested, however, if the adviser follows the practice of trading upon

the predictable market effect of his own recommendations, since his personal financial interest in the effect of his advice is likely to influence his judgment. Such a practice creates conflicts of interest between his duties to his clients and his personal interest. It is immaterial that respondents may have believed in the soundness of their recommendations or made them without conscious intent to advance their personal trading interests. Respondents' non-disclosure of their trading activities constituted a fraud and deceit upon their clients because such information would be important to the clients in evaluating the recommendation. For example, clients are entitled to know that an adviser is following a practice of selling for short-term gains stock which he recommends be purchased for long-term profits, and that he had already purchased the recommended stock and might therefore be reluctant to change his recommendation before issuing it despite newly acquired adverse information.

The courts have repeatedly recognized that it is fraud and deceit under substantially identical language of Section 17(a) of the Securities Act of 1933 for a securities dealer to recommend securities without fully disclosing all pertinent facts about his interest in the transaction, and that the failure to disclose such information is not excused because the dealer "honestly" believes in the advice he gives. Indeed, the fiduciary duty of disclosure in the present case is even clearer than in those cases under the 1933 Act, since in those cases the dealers gave free investment advice, whereas in the present case respondents charged for their service.

B. Nothing in either the legislative history or the language of the 1960 amendments to the Investment Advisers Act justifies the narrow interpretation of the statute adopted by the court below. The legislative history does not show that either Congress or the Commission believed that the Act as it then stood did not proscribe non-disclosure by an investment adviser of trading on the market effect of his recommendations. Neither of the two changes made by the addition of Section 206(4) in 1960—the grant to the Commission of rule-making power and the addition of the word "manipulative" to the description of the practices specifically prohibited—justifies the conclusion that the broad anti-fraud provisions of Section 206(1) and (2) do not prohibit "scalping."

ARGUMENT

Respondents Violated Section 206(1) and (2) of the Investment Advisers Act By Failing To Disclose Their Trading In the Securities Which They Recommended.

The respondents provide an investment advisory service, designed to aid investors in making long-term capital gains, which they sell to 5000 subscribers for $18 a year. In addition to the income thus derived, they made personal profits of almost $20,000 during a seven-month period by repeatedly trading on the market effects of their recommendations. Their course of conduct was to purchase a security shortly before recommending it as a long-term investment, and then to sell it at a profit a few days later after the security had enjoyed the rise in price which customarily follows a recommendation by an investment service.

The advisers did not disclose to their clients any aspect of their personal transactions in the recommended securities, and the clients presumably believed that in return for their $18 a year they were receiving entirely disinterested advice.

Section 206 (1) and (2) of the Investment Advisers Act of 1940 makes it unlawful for an investment adviser, by use of the mails or the facilities of interstate commerce—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

The question presented is a narrow one: whether respondents' failure to disclose their practice of trading upon the predictable market effect of their advice constitutes a "device, scheme, or artifice to defraud" or a "practice, or course of business which operates as a fraud or deceit" within the meaning of the foregoing provisions. In view of the suggestion of the majority below (R. 70) that the problems of "a material adverse interest in securities which the adviser is recommending" could be dealt with by rulemaking, it is important to point out that this case does not present the broad question whether, and in what circumstances, an investment adviser must disclose his interest in or ownership of securities which he recommends. That broad question may arise in many contexts, in some of which there may be no need for disclosure of the adviser's interest, and those aspects of the problem which call for regulation may properly

be dealt with through rulemaking. As we show below (*infra*, p. 33), however, the specific practice involved in the present case—an adviser's secret trading upon the predictable market effect of his own recommendations—is fraudulent irrespective of specific rules.

The Commission submits that respondents were under a fiduciary obligation to their clients to render disinterested advice, and that they violated that duty by failing to disclose their trading practices in the securities they recommended. Such a breach of respondents' fiduciary duty constituted a fraud and deceit upon their clients under Section 206(1) and (2).

A. *An Investment Adviser Has a Fiduciary Obligation to His Clients Not to Trade Secretly upon the Market Effect of His Advice.*

As the majority below recognized (R. 65), there cannot "be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised." The rendering of investment advice calls for knowledge and abilities not possessed by the average investor, who in selecting an adviser necessarily relies upon his good faith and integrity. The adviser thus acts as a fiduciary. Cf. *Arleen Hughes v. Securities and Exchange Commission*, 174 F. 2d 969, 971, 975, 976 (C.A. D.C.).

The only thing that an investment adviser has to sell is advice based on his expert judgment. Such advice, if it is to meet the high ethical standards which

the law imposes upon fiduciaries, must be disinterested, and the clients of an investment adviser have the right to assume that it is. Investment advice cannot be disinterested, however, if the adviser intends to profit from its effects. For in such a situation the adviser, even though he "honestly" believes in the soundness of his recommendation, may nevertheless be influenced by its probable effect on his personal fortunes.

In the present case, the record shows that the stock which respondents recommended for long-term gains in each of six monthly bulletins during a seven-month period had been purchased by them shortly before the recommendation, and that in each instance they soon sold the stock at a profit. The majority below properly recognized (R. 65) the truism of the securities business that "the predictable market effect" of such an investment adviser's recommendation ordinarily is a rise in the stock's price.[5] An investment adviser who

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[5] At first blush, one might assume, as did the majority in the panel decision below (R. 50-51), that the recommendation of an investment service sent to 5000 subscribers covering a stock with millions of shares outstanding would be unlikely to have any significant effect upon its market price. The fact is, however, that "[m]arket activity, under normal trading conditions, takes place not in the entire outstanding issue of a security but in that portion known as the floating supply * * * [which is] composed principally of shares registered in the names of brokers or nominees, as distinguished from those registered in the names of the beneficial owners." Securities and Exchange Commission, *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* (1936), p. 31. And see Crane, *The Sophisticated Investor* (1959), pp. 212-213; Friend, Hoffman and Winn, *The Over-the-Counter Securities Markets*

thus personally trades upon the predictable market effect of his own recommendations inevitably creates a conflict of interest between his duty to his clients and his personal interest.

(1958), p. 35; *New York Stock Exchange Fact Book* (1961), p. 42.

The record shows that shortly after respondents' recommendations there were substantial increases in the volume of trading in the stocks recommended (R. 15-17). Economists and financial writers have recognized that the recommendations of advisory services such as respondents' do have a significant effect upon the market activity in the stocks recommended by them. See, *e.g.*, Ruff, *Effect of a Selection and Recommendation of a "Stock of the Month"*, Financial Analysts Journal, March-April, 1963, p. 41; *Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 1*, H. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess., p. 372; *Hearings on H. J. Res. 438 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 87th Cong., 1st Sess., p. 101 (testimony of Keith Funston, President, New York Stock Exchange); New York Stock Exchange, Educational Circular No. 170, November 16, 1962, discussed in the Wall Street Journal, November 19, 1962, p. 4, cols. 2, 3.

Indeed, one writer specifically listed respondents' service as among those which are likely to affect prices: "Traders have to watch carefully for tips from investment services, outfits such as Standard & Poor's Outlook, Moody's, Fitch's, United Business Service, Value Line, *Capital Gains Research*, John Magee, Garfield A. Drew and others. Many of them, like the bigger brokerage houses, have substantial followings. Their definite recommendations bring quick action." Crane, *The Sophisticated Investor* (1959), p. 67 (emphasis added).

The same writer, in describing the trading on the New York Stock Exchange on the business day following the mailing of respondents' bulletin on Hart, Schaffner & Marx, stated: "Hart Schaffner & Marx had the biggest move in response to investment advice. It gained 2-1/4 to 25-1/4 on the twin suggestions that the dividend might be increased

Respondents generally recommended a single security each month. Since they made a practice of scalping, might not their choice of a stock to recommend be influenced, consciously or unconsciously, by their judgment as to which was most likely to rise in response to their recommendation?[6] Or suppose that respondents had decided to recommend a particular security and, while the recommendation was being prepared, had purchased the stock. If at that point they learned something which reflected adversely on the stock—perhaps they received a confidential report that the company's earnings had taken a downward turn—would they change their recommendation and thus perhaps suffer a loss on the securities already purchased? We are not suggesting that these hypothetical situations occurred here. We refer to these possibilities only to point out the vices inherent in permitting an adviser to trade secretly on his own recommendations.

The maxim that "no man may serve two masters

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and that not much stock was outstanding.'" N.Y. Times, Aug. 16, 1960, p. 40, col. 8. (Respondents' recommendation suggested the possibility of a dividend increase, and referred to the small number of shares available. R. 41.)

Two days after the mailing of respondents' bulletin on Union Pacific stock another financial writer stated: "Union Pacific, with substantial oil interests, stood out among the rails with a gain of 1-1/8 in active trading. There was also a recommendation on the issue." N.Y. Times, Nov. 3, 1960, p. 58, col. 3.

[6] The price sensitivity of particular stocks to such a recommendation would be influenced by their "floating supply," that is, the number of shares available for trading, as distinguished from the total number outstanding. See note 5, *supra*.

* * * is especially pertinent if one of the masters happens to be economic self-interest" (*United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 549). A fiduciary who is subject to the pull of conflicting interests cannot justify his conduct on the ground that "he served his several masters equally well or that his primary loyalty was not weakened by the pull of his secondary one" (*Woods* v. *City National Bank & Trust Co.*, 312 U.S. 262, 269). The reason such conflicting interests are condemned "is not because such interests are always corrupt but because they are always corrupting" (*Mosser* v. *Darrow*, 341 U.S. 267, 271).

It is thus immaterial that respondents' advice in this case may have been "honest" in the sense that they believed it was sound and did not formulate it consciously for the purpose of furthering their personal pecuniary objectives. By secretly trading on the market effect of their recommendations, respondents violated their fiduciary obligation to provide their clients with disinterested investment advice. In *Wolf* v. *Weinstein*, 372 U.S. 633, this Court recently held that two corporate officers who had traded in the debtor's stock during reorganization were required by Section 249 of the Bankruptcy Act to refund the compensation they had received during the reorganization, even though they had rendered "beneficial services to the Debtor" and "the trading involved small amounts of stock and was carried on apparently in good faith and without knowledge of the existence of § 249 * * * " (pp. 653-654). The Court applied this "harsh" (p. 654) remedy because Section 249 was in-

tended to apply "the historic maxim of equity that a fiduciary may not receive compensation for services tainted by disloyalty or conflict of interest" (p. 641). An investment adviser who renders investment advice for compensation is subject to no lower standard of fiduciary duty.

B. *Respondents' Secret Trading in the Securities They Recommended Constituted a Fraud and Deceit on Their Clients in Violation of Section 206(1) and (2) of the Investment Advisers Act.*

1. The Investment Advisers Act was the last of a comprehensive system of six federal regulatory statutes aimed at abuses in the securities industry. As the dissenting opinion points out (R. 78), it was "designed to protect 'the public' 'from the frauds and misrepresentations of unscrupulous tipsters and touts' and to safeguard bona fide investment counsel 'against the stigma of the activities of these individuals' ".[7] One of the evils against which Congress sought to protect investors was possible conflicts of interest between them and their advisers. Thus the Commission's report to the Congress, which provided the impetus for the legislation, stated (emphasis added):

> Broadly stated, the representatives [of the investment counseling industry] felt that investment counsel organizations could not completely perform their basic function — furnishing to clients on a personal basis competent, unbiased,

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[7] The dissenting opinion is quoting from the Senate Committee report on the Act: S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21.

and continuous advice regarding the sound management of their investments—*unless all conflicts of interest between the investment counsel and the client were removed.*[8]

When Congress made it illegal in Section 206(1) and (2) for any investment adviser "to employ any device, scheme, or artifice to defraud" or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon" any client, it was not using novel language. The provisions were obviously derived from the almost identical language of Section 17(a) of the Securities Act of 1933 (App. *infra*, p. 35), which makes it unlawful for any person, in the offer or sale of securities, "(1) to employ any device, scheme, or artifice to defraud, or * * * (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[9] Since these two provisions are *in pari materia*, it is appropriate to look to the decisions construing Section 17(a) of the

[8] *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission—Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, H. Doc. No. 477, 76th Cong., 2d Sess., p. 28.

[9] Section 10 of the Securities Exchange Act of 1934 (App. *infra*, p. 36) prohibits "any manipulative or deceptive device or contrivance * * *," and Rule 10b-5 of the Commission's rules under that Act (adopted in 1942) (App. *infra*, p. 37) contains language almost identical to the provisions of Section 17(a) of the Securities Act of 1933 quoted in the text. See also Section 15(c)(2) of the 1934 Act (App. *infra*, pp. 36-37), which prohibits any broker or dealer from engaging in any "fraudulent, deceptive, or manipulative act or practice."

Securities Act in interpreting Section 206(1) and (2) of the Investment Advisers Act.[10] See 3 Loss, *Se-*

[10] Section 17(a) of the Securities Act contains, in subsection (2), a provision not included in Section 206 of the Investment Advisers Act, namely, a prohibition against "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." This difference between the two statutes, however, does not make the decisions under the 1933 Act any less pertinent in construing Section 206. For, as discussed below in the text, those decisions recognize that the nondisclosures there involved constituted fraud and deceit within the meaning of subsections (1) and (3) of Section 17(a). Moreover, it has been held with respect to the Commission's Rule 10b-5, which contains three subdivisions substantially identical to those in Section 17(a), that "[t]he three subparagraphs of this broadly remedial rule are mutually supporting and not mutually exclusive" so that a breach of a "duty of disclosure * * * can be viewed as a violation of all three subparagraphs of the Rule, i.e., (1) a device, scheme, or artifice to defraud; (2) an implied misrepresentation or misleading omission; and (3) an act, practice or course of business which operates or would operate as a fraud upon the plaintiffs." *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del.), modified on other grounds, 235 F. 2d 369 (C.A. 3).

While the legislative history does not reveal the reason for the absence in the Investment Advisers Act of a provision comparable to Section 17(a)(2), it may have been omitted because of concern that its inclusion would have required investment advisers to give full descriptions of all securities which they recommend. Many investment advisers do not provide, and their clients do not expect, detailed information about securities recommended as "good buys." Moreover, as pointed out by the dissent below (R. 79), since Section 17(a)(2) prohibits only "obtain[ing] money or property" through non-disclosure, its primary function obviously is to regulate purchases and sales of securities rather than to regulate rendition of investment advice.

curities Regulation (2d ed. 1961), 1515.

The courts have repeatedly recognized that it is fraud and deceit under the 1933 Act for a securities dealer to recommend securities without fully disclosing all pertinent facts about his interest in the transaction, and that the failure to disclose such information is not excused because the dealer honestly believes in the advice he gives. Thus, in *Charles Hughes & Co.* v. *Securities and Exchange Commission*, 139 F. 2d 434 (C.A. 2), certiorari denied, 321 U.S. 786, a securities dealer who sold securities to his customers at prices substantially above the market without disclosing his mark-up was held to have violated Section 17(a) of the Securities Act, even though the dealer believed that his prices were fair. The court stated that this practice "operated as a fraud and deceit upon the purchasers," since the dealer was "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions" (139 F. 2d at 436-437). In *Norris & Hirshberg* v. *Securities and Exchange Commission*, 177 F. 2d 228 (C.A. D.C.), a securities dealer engaged in "churning"—described by the court as "the continual shuffling of securities back and forth in * * * customers' accounts" (177 F. 2d at 232)—making a profit on each transaction with his customers. The court ruled that these activities could "only be described as manipulative, deceptive, and fraudulent" (*id.* at 233) in violation, *inter alia*, of Section 17(a) of the Securities Act and Rule 10b-5 under the Securities Exchange Act.

In upholding the revocation of another dealer's registration in *Arleen Hughes* v. *Securities and Exchange Commission*, 174 F. 2d 969 (C.A. D.C.), the same court held that the dealer, who was also an investment adviser, violated Section 17(a) of the Securities Act and the anti-fraud provisions of the Securities Exchange Act by failing to advise her clients of the current market prices and the cost to her of the securities she recommended and sold to them. The fact that the clients had been afforded "a high degree of investment protection, financial gain and security and financial peace of mind * * *" (*id.* at 974) provided no defense. Similarly, in *Securities and Exchange Commission* v. *Torr*, 15 F. Supp. 315 (S.D. N.Y.), reversed on other grounds, 87 F. 2d 446 (C.A. 2), reaffirmed on remand, 22 F. Supp. 602, the district court held that certain defendants violated Section 17(a) of the Securities Act of 1933 by recommending a stock allegedly "solely on its merit" (15 F. Supp. at 317), but without disclosing that they were being paid for making the recommendation. The court stated (*id.* at 317) that such nondisclosure "operated as a deceit on purchasers", since "[w]hen a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived." [11]

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[11] Other decisions which have interpreted the anti-fraud provisions of federal securities legislation to impose upon fiduciaries a broad duty of disclosure in securities transac-

Indeed, long before the Investment Advisers Act it had been recognized that an investment adviser commits a fraud upon his clients if he fails to disclose his personal interest in a security he recommends. In *Ridgely* v. *Keene*, 134 App. Div. 647, 119 N.Y. Supp. 451 (2d Dept., 1909), an investment adviser published a market letter in which "he undertook to * * * give [subscribers] impartial and unbiased advice respecting stock market matters" (134 App. Div. at 648). He entered into a contract with stockbrokers by which he agreed, for compensation, to influence his subscribers to purchase a particular stock in which the brokers had a pool. The court refused to enforce the contract, holding that it was one "to perpetrate a fraud upon * * * [the] subscribers" and that the adviser's conduct was "a palpable fraud upon them" (*id.*, at 649). In rejecting the adviser's attempt to justify the conduct on the ground he "honestly believed" that his clients would profit through buying the stock, the court stated (*ibid.*):

> * * * his belief in the soundness of his advice is wholly immaterial. The law takes into account human frailty, and absolutely forbids the assumption of conflicting obligations and duties, and refuses to inquire whether the person assuming

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tions include *Speed* v. *Transamerica Corp.*, 235 F. 2d 369 (C.A. 3), affirming 99 F. Supp. 808 (D. Del.); *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767.

> inconsistent relations really supposed he was faithful to both. * * * [12]

See, also, *United States* v. *Buckner*, 108 F. 2d 921 (C.A. 2), certiorari denied, 309 U.S. 669, where officials of a bondholders' protective committee were held to have violated the mail fraud statute by a scheme to acquire foreign bonds about to be defaulted, without disclosing to the bondholders that they had reason to believe that the foreign government would probably pay the bonds. The court stated (p. 926): "Using a fiduciary position as a protective committee member to obtain secret profits based upon inside information is not only a breach of trust, but an active fraud on the bondholders."

The fiduciary duty of disclosure in the present case is even clearer than in the foregoing cases involving securities dealers. For in those cases the dealers were held to have violated the anti-fraud provisions of the securities acts by giving investment advice free of charge [13] without revealing their financial interest in

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[12] Cf. *Magruder* v. *Drury*, 235 U.S. 106, 120:

> It makes no difference that the estate was not a loser in the transaction or that the commission was no more than the services were reasonably worth. It is the relation of the trustee to the estate which prevents his dealing in such way as to make a personal profit for himself. * * * While no wrong was intended, and none was in fact done to the estate, we think nevertheless that upon the principles governing the duty of a trustee, the contention that this profit could not be taken by [the trustee] * * * should have been sustained."

[13] Except, perhaps, in the *Arleen Hughes* case, *supra*, p. 23, where the dealer contended that her high charges reflected the investment advice she provided. See 174 F. 2d at 971.

the recommendations. Here, in contrast, the 5,000 subscribers to respondents' "Capital Gains Report" paid $18.00 a year for the service.

Respondents' failure to disclose to their clients their trading on the market effect of their recommendations constituted a fraud and deceit upon such clients in violation of Section 206(1) and (2), because the clients were entitled to such information in evaluating the advice. It would be highly relevant to an investor, to whom a particular stock was recommended for a long-term capital gain, to know that respondents had already purchased the stock, not for a long-term pull, but with the view of selling it in a few days for a short-term profit following the "predictable" price rise which results from such a recommendation. Moreover, the knowledge that respondents were thus trading in recommended stocks might be important to existing subscribers in determining whether to continue the service and to prospective subscribers in determining whether to purchase it. An investor who did know the facts would certainly ask himself whether respondents' practice might not have influenced their recommendation; and why they were selling what they advised others to buy and hold. It is immaterial whether respondents' answers would have satisfied their clients. While the quality of the recommendations might be such as to lead investors to continue or to purchase the service despite respondents' "scalping," the important thing is that the clients, in order to exercise an informed judgment, were entitled to know the facts.

Moreover, since the only thing an investment adviser has to sell is his own personal judgment, any fraud and deceit he may commit will almost invariably consist of misrepresenting, explicitly or implicitly, the character of the advice he is furnishing. In most instances, such misrepresentation will take the form of non-disclosure, and while the non-disclosures may relate to different aspects of the adviser's practices,[14] they have one common thread: the adviser fails to disclose to the client a fact which is material to the client in deciding whether to follow the advice.

The majority opinion recognized (R. 65) that "federal securities laws are to be construed broadly to effectuate their remedial purpose." As the dissent pointed out (R. 80), however, the effect of the majority's interpretation of Section 206(1) and (2) is "that an adviser can escape liability for scalping unless the SEC affirmatively proves he disbelieved his own recommendations." Since the Commission could rarely, if ever, make such a showing, the decision below, as the dissenters pointed out (R. 85), "sanctions and indeed endorses a low standard of business morality." By giving the remedial provisions of Section 206(1) and (2) an unduly narrow reading, it denies to clients

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[14] An adviser might make a consciously false recommendation, *i.e.*, one which he does not believe. Or he might "honestly" believe in the soundness of his advice, but fail to disclose that he has a personal interest in the recommendation, either because he is paid to make it (as in the cases discussed *supra*, pp. 22-23), or because he intends to trade personally on the market reaction to it (as in the present case).

of an investment adviser the protection against concealment of material facts which the anti-fraud provisions of the Investment Advisers Act were intended to provide.[15]

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[15] The court below stated (R. 64) that since the case involved "an application for a preliminary injunction in advance of a trial upon the merits," the "only question presented at this stage of the proceedings * * * is whether a violation * * * has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial." We believe that the decision below turns solely on the court's substantive holding that undisclosed scalping does not violate the Act. But see *Walters* v. *Moore-McCormack Lines, Inc.*, 312 F. 2d 893, 896 (C.A. 2), where Chief Judge Lumbard, in summarizing the issues involved in each of the 30 cases heard by the court *en banc*, described the present case as involving the question "whether a violation of the Investment Advisers Act * * * was so clear as to justify a preliminary injunction." See also the statements by the majority of the panel below as to the stringent showing necessary for a preliminary injunction (R. 47-48).

To the extent that the court below may have suggested that the Commission is under a particularly heavy burden of proof before it can obtain a preliminary injunction, it was clearly in error. The preliminary injunction is usually the agency's most effective enforcement tool for protecting the public against fraud, and the Commission need show only that there is a likelihood that violations have occurred and, unless restrained, are likely to continue. This is particularly so where, as in the present case, the only sanction involved is a requirement of full disclosure pending the trial on the merits. See *Securities and Exchange Commission* v. *Boren*, 283 F. 2d 312, 313 (C.A. 2). Cf. *Douds* v. *International Longshoremen's Ass'n.*, 242 F. 2d 808, 810-811 (C.A. 2); *Federal Trade Commission* v. *Rhodes Pharmacal Co.*, 191 F. 2d 744, 746-747 (C.A. 7); *Bowles* v. *Montgomery Ward & Co.*, 143 F. 2d 38, 42 (C.A. 7).

2. In 1960 Congress amended Section 206 of the Investment Advisers Act to add Subsection (4), which makes it unlawful for any investment adviser

> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

This subsection made two substantive changes in the scope of the existing provisions. It added to the prior prohibitions of "fraudulent" and "deceptive" practices a specific prohibition of "manipulative" practices; and it authorized the Commission to promulgate rules and regulations to define, and prescribe means designed to prevent, fraudulent, deceptive or manipulative acts, practices and courses of business. The majority of the court of appeals stated (R. 67-68) that the history of the 1960 amendments "confirms the narrow scope of the initial enactment"; it also apparently deemed it significant that the 1960 amendments gave the Commission broad rule-making power to deal with the subject and added "manipulation" to the categories of prohibited conduct. Neither of these points is valid.

a. The legislative history of the 1960 amendments does not show that either Congress or the Commission believed that the Act as it then stood did not proscribe non-disclosure by an investment adviser of his trading on the effect of his recommendations. This

history consists of statements and memoranda of Commission representatives submitted in support of the various proposed amendments to the Act, and Congressional committee reports which draw conclusions from these materials. As the dissent below pointed out, this history is at most of only slight relevance, since it consists "of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act" (R. 76) and does not reflect the views of the Congress which enacted the original legislation. See *United States* v. *The Philadelphia National Bank*, No. 83, Oct. Term, 1962, decided June 17, 1963; *Rainwater* v. *United States*, 356 U.S. 590, 593.

More specifically, neither these 1959-1960 legislative materials nor the doubts expressed by the Commission concerning the reach of the statute and the need for rule-making powers were addressed to the issue presented here—the legality of "scalping." Commission representatives testified, moreover, that in some cases failure to disclose an interest in a security might involve a fraud upon a client within the meaning of Section 206 of the Act.[16]

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[16] The majority opinion below refers (R. 68) to a Report of the Subcommittee on Legislative Oversight which indicates that the failure of an investment adviser to disclose to his clients the interest of a mutual fund, of which he was also adviser, in a security recommended by him did not violate Section 206(1) and (2) of the Act. *Independent Regulatory Commissions*, Report of the Special Subcommittee on Legislative Oversight of the Committee on Interstate and Foreign Commerce, H. Rep. No. 2711, 85th Cong., 2d Sess., pp. 53-54. But the testimony of Commission personnel, upon which the

The Commission has never taken the position that the anti-fraud provisions do not reach the scalping practices here involved, which go far beyond the mere recommendation of a security in which the adviser has an interest, since here the adviser made a practice of reaping a personal profit from trading on the market effect of his recommendations. The views expressed by the Commission in connection with the 1960 legislation concerned the need for rule-making powers to proscribe non-fraudulent practices which, in the Commission's judgment, might lead to fraud. Since scalping constitutes fraud under Section 206 (1) and (2), its illegality is unaffected by these views.

That the Commission has always so believed is borne out by its enforcement action. In 1946, the Commission acted under Section 206(2) in proceeding against scalping practices indistinguishable from those permitted by the court below. See *Securities and Exchange Commission* v. *Frank Payson Todd,* Civil No.

Report rested that conclusion, was that there was nothing wrong in such non-disclosure because the investment adviser in the particular situation did not necessarily have any personal interest in the securities owned by the mutual fund. See *Investigation of Regulatory Commissions and Agencies*, 85th Cong., 2d Sess., Part 12 (Hearings of Sept. 17, 1958), p. 4840. In reply to the question whether it was not the purpose of the Act to require full disclosure by an adviser concerning any interest it might have, directly or indirectly, in a recommended security, a member of the Commission's staff stated that "* * * failure to make such disclosure might involve a fraud upon the client within the meaning of section 206 of the act." *Id* at p. 4839.

6149 (D. Mass.)."[17] Cf. *Seipel* v. *Securities and Exchange Commission*, 229 F. 2d 758 (C.A.D.C.).

b. Nor can the majority's narrow interpretation of subsections (1) and (2) be justified by the fact that 20 years later Congress gave the Commission rule-making power which concededly would authorize a rule proscribing, as a "means reasonably designed to prevent" fraud, non-disclosure of the type here involved. For proceeding under such a rule would not be an effective substitute for the application of the

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[17] In that case, the defendant admitted the allegations of the complaint and consented to the entry of an injunction. Securities and Exchange Commission Litigation Release No. 372, November 14, 1946, describes the defendant's activities as follows:

> The complaint alleged that Todd defrauded investment advisory clients in the following manner: Todd issues a weekly letter, "The New England Counsellor," in which he advises subscribers with respect to the purchase of securities. He also has certain clients who for an additional fee obtain more personalized advice, and until recently he managed a number of discretionary accounts. Todd would withhold making his recommendation to purchase specific securities for several days, during which he would purchase the security for his discretionary accounts and orally recommend its purchase to clients receiving more personalized advice. It would usually be an inactive security and, when the market had been raised by the subscribers' purchases, Todd would sell the security in his discretionary accounts, meanwhile continuing to recommend its purchase in his weekly letter.

The Commission's complaint alleged that Todd "managed a discretionary account in the name of his wife, Mary K. Todd."

The injunction was later vacated on grounds not germane here. 3 Loss, *Securities Regulation* (2d ed. 1961), 1516.

"general and flexible" anti-fraud provisions which the courts have long recognized as necessary to keep in check "the versatile inventions of fraud-doers." *Stonemets* v. *Head*, 248 Mo. 243, 154 S.W. 108, 114; and see *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795, 803 (C.A. 8), certiorari denied, 319 U.S. 767. Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202-203; *State* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077, 1079. If the Commission is to prevent clever operators from keeping one step ahead of the enforcement officers, it should not be limited to proceeding by rules which attempt to catalogue in advance every species of fraud. The Commission, of course, has the discretion to determine whether to proceed by rule or through *ad hoc* enforcement litigation (Cf. *Chenery* case, *supra*), and the fact that it could have acted under its rule-making power does not justify a restrictive reading of the substantive provisions it invoked in seeking an injunction.[18]

c. Finally, the fact that subsection (4) specifically prohibits "manipulative" practices does not suggest that the terms "fraud" and "deceit" in subsections (1) and (2) are to be read narrowly. For it is by no means certain that "manipulative" is any broader

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[18] The Commission has promulgated two rules under Section 206(4). They make it a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser (1) to use certain advertising, or (2) to fail to follow specified procedures respecting clients' funds or securities which are in the adviser's custody or possession. 17 CFR § 275.206 (4) 1 and 2 (Cum. Supp.).

than the other two terms,[19] and it therefore does not follow that even if respondents' non-disclosure were neither fraudulent nor deceitful, it could be prohibited as "manipulative."

CONCLUSION

The judgment of the court of appeals should be reversed, and the case remanded with instructions to enter a preliminary injunction.

Respectfully submitted.

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JULY 1963.

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[19] See, for example, Section 15(c)(1) of the Securities Exchange Act (15 U.S.C. 78o(c)(1)) which refers to devices "as are manipulative, deceptive, or *otherwise* fraudulent" (emphasis supplied). See also *Norris & Hirshberg* v. *Securities and Exchange Commission, supra*, 177 F. 2d at 233. And cf. *United States* v. *Brown*, 79 F. 2d 321, 325 (C.A. 2), where in a case arising under the mail fraud statute, 18 U.S.C. 338, Judge Learned Hand explained: "Wash sales [a common form of manipulation] are a deceit, because they broadcast the fact that a buyer and a seller have agreed to exchange the shares at a published price, when they have not done so."

APPENDIX

1. The Securities Act of 1933 (48 Stat. 74, 84, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

> An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.
>
> * * * * *
>
> FRAUDULENT INTERSTATE TRANSACTIONS
>
> SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
>
> * * * * *

2. The Securities Exchange Act of 1934 (48 Stat. 881, 891, 895, as amended, 15 U.S.C. 78a, *et seq.*) provides in pertinent part:

An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

* * * *

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

OVER-THE-COUNTER MARKETS

SECTION 15.

* * * *

(c) (2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with

which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

* * * *

3. Rule 10b-5 (17 C.F.R. 240.10b-5) issued pursuant to the Securities Exchange Act of 1934 provides:

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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